



## CONSULTING ASSISTANCE ON ECONOMIC REFORM II

# REPORTS

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### **Tax and Legal Issues Relating to Regulating Public Benefit Organizations (Sponsorship Donees)**

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# Tax and Legal Issues Relating to Regulating Public Benefit Organizations (Sponsorship Donees)

## Outline (Draft - June 12, 2000) Neil Brooks

This outline was put together in a short period of time and borrows liberally from any relevant documents within reach. Its purpose is simply to provide some structure for a seminar on aspect of the legal and tax issues relating to the regulation of public benefit organizations. It attempts to set out a relatively comprehensive set of questions that must be answered in drafting a legal regime for regulating and taxing public benefit organizations. In places it simply sets out the relevant questions; in other places it provides a set of criteria that might be referred to in answering the questions; in other places it reviews the competing considerations; in others it suggests a preferred answer; and, in other places it provides the law in other jurisdictions (often Canada).

The questions are grouped generally under the following headings:

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## I. Importance of Public Benefit Organizations

### I. What Are the Reasons Why a Country Should Want Vigorous, Strong and Independent NGOs and a Flourishing Civil Society?

#### A. Society Has Four Important Sectors

1. Government
2. Markets
3. Civil society (variously referred to as the third sector, voluntary sector, nonprofit sector, charitable sector - usually defined as the realm of organized social life that is voluntary, not profit seeking, self-generating, self-supporting, autonomous from the state, and bound by the legal order)
4. Families and informal associations

#### B. Role of Civil Society

##### 1. Importance in delivering services

###### a) Why NGOs and not government?: public good argument

- (1) For the provision of some public goods NGOs are likely to be more efficient, innovative, flexible, particularistic, and pluralistic than government

###### b) Why NGOs and not markets?: market failure argument

- (1) For the provision of some private goods, particularly goods or services that consumers have difficulty evaluating and yet are vital for their well being (for example child care, education or health services) consumers are more likely to trust an NGO than a for-profit corporation.
- (2) Governments around the world are continuing to transfer assets and download services to NGOs in an effort to reduce the apparent size of government. In some cases it makes sense to deliver what are essentially government services through NGOs, but in many cases this type of downloading is inappropriate and imperils both the traditional functions of government and those of civil society.

##### 2. Importance in fostering associational life

###### a) The Promotion of Social Cohesion

- (1) Promotes pluralism and tolerance
- (2) Promotes social stability and rule of law
- (3) Promotes social capital and a willingness of citizens to cooperate with one another since through NGOs they realize they have much in common with others who have different backgrounds and experiences
1. NGOs are the primary means of connecting people to each other in society
- (4) When interaction occurs across different groups in society (for example across social, linguistic, cultural or geographic groups) increased tolerance and social cohesion are more likely to occur

###### b) The Enrichment of Democracy

- (1) Promotes freedom of speech and association
- (2) Constrains the power of democratic governments by checking their potential abuses and violations of the law, and subjecting them to public scrutiny
- (3) Provides a forum for citizens to develop skills in participating in democratic deliberation and to develop skills of leadership
- (4) A forum for the recruitment and training of new political leaders
- (5) Allows for development of democratic attributes such as tolerance, moderation, ability to see other perspectives and of the need for

compromise

(6)Provides a forum for the articulation of community interests other than those represented by business interests

(7)Provides a valuable source of information to policy-makers because NGOs develop expertise in particular areas of public policy

(8)Enhances the accountability, responsiveness, inclusiveness, effectiveness and hence the legitimacy of the political system

c)The Efficiency of Markets

(1)Increase the efficiency of markets by disseminating information about market producers, such as that done by consumer protection groups and environmental organizations.

(2)The also provide indirect support for the market economy by encouraging social cooperation, trust and social networks. There is a large body of literature that suggests that markets cannot operate effectively on the basis of legal rules of property and contract law alone (as economic textbooks would like us to believe). Efficient markets rely upon a high degree of trust and cooperation between producers and consumers. Civil society lays the foundation for this trust. Recent cross-national studies have shown that those societies in which there is a high level of trust tend to be more prosperous.

**II. What Criteria Should be Used in Drafting and Evaluating the Rules Relating to Organizations in Civil Society?**

A. Equality

1. Everyone, regardless of income or station in life, ought to have an equal voice in civil society

B. Autonomy and Independence

1. Civil society should, to the extent possible, be independent of government control and the forces of the market economy. NGOs should be self-governing.

C. Accountability and Transparency

1. To the extent that NGOs receive government finances - for example the implicit subsidy provided through tax concessions - all aspects of their work should be transparent and they should be held strictly accountable for the spending of this money. Aside from anything else, NGOs have an interest in being held accountable and their work being transparent. Citizens will not contribute to, or cooperate with, NGOs unless they are confident how their money is raised, how it is being spent, and what results are being achieved through their work.

D. Simplicity

1. To encourage as much participation as possible in civil society, the rules governing NGOs must be simple and inexpensive to comply with. Participants in civil society should be able to undertake their public benefit activities without being unduly burdened with administrative tasks.

E. Aside

1. Having good laws for NGOs is a necessary condition for the establishment of a strong, independent, accountable and transparent civil society, but it is not a sufficient condition. Obviously the emergence and capacity of NGOs is dependent not only upon legal considerations but also upon a range of sociological and economic considerations.

## II. A Prerequisite for a Public Benefit Organization - A Non-Profit Organization

### III. Should an Organization Have to Register as a Non-Profit Organization Before It Can Apply for Registration as a Public Benefit Organization?

A. The short answer to this question is “yes.” That means, of course, that an organization that wishes to apply for registration as a public benefit organization must first apply for registration as a non-profit organization. Thus, it must register twice. Since there appears to be some resistance in Lithuania on the part of some NOGs to registering twice, in answering this question I will briefly set out the separate justifications for nonprofit organizations and public benefit organizations. Also, in Lithuania there appears to be at least four statutes under which an organisation might register in order to become a recognized nonprofit organization. I will suggest that this is needlessly confusing and can lead to unexpected results. Perhaps these four statutes could be redrafted as only one statute that governs the registration of all nonprofit organizations.

### IV. What Is the Purpose of Statutes that Deal with the Registration of Nonprofit Organizations?

#### A. The Purpose of Nonprofit Organizations

1. Most jurisdictions have an incorporation procedure (or a registration procedure) for all nonprofit organizations. These are organizations in society that have two major characteristics: (a) they are formed for reasons other than to make a profit and (b) they cannot distribute property to their members prior to dissolution. They include social, athletic, service, trade, professional, and community clubs and associations. That is, they include almost every organization in society except corporations that are formed to earn a profit. They might be broadly subdivided into religious, political, public benefit, mutual benefit and other general nonprofit organizations. Many jurisdictions only have one statute that governs the incorporation or registration of all of these organizations.

#### B. The Purposes of Nonprofit Organisation Statutes:

- a) To give social and other nonprofit organizations a legal personality so that they can contract and hold property in their own right.
- b) To provide the organization with perpetual existence.
- c) To provide the members of the organization with limited liability (that is, to ensure that the members of the organization will not necessarily be liable for the wrongful acts of some other members).
- d) To provide rules that govern the relationship between the members and the governing body of the organization to ensure that all members of such organizations have rights and must be dealt with fairly and according to the law by other members and by the governing body of the organization. That is, these statutes impose a form of democracy on all members of nonprofit organizations. They ensure that citizens can become members of nonprofit corporations knowing that their interests will be protected by the law. These rules are essentially default rules for such organizations ensuring fair dealing between the members.

C. All nonprofit corporation statutes, in every country, have to deal with essentially the same issues. I set out in the next paragraph the outlines of a model nonprofit organization statute. I do this for two reasons. First, to illustrate how the objectives of these statutes are achieved and how they differ from the types of provisions that are found in a typical statute that governs public benefit organizations. That is, to illustrate that a public benefit organization is an organization that must not only have the rules of nonprofit organizations apply to it, but also additional rules to ensure that

it qualifies for special tax concessions. Second, if one wished, one could examine the four statutes in Lithuania that govern nonprofit organizations and see that the provisions they contain could easily be fitted within this model outline of provisions.

## **V.What Provisions Should a Model Nonprofit Organization Statute Contain?**

### **A.Outline of a Model Nonprofit Organization Statute**

#### **1.Definition and Attributes**

##### **a)Capacity and powers of the organization**

- (1)General capacity
- (2)Ownership of land
- (3)Incidental powers
- (4)Borrowing and finance

##### **b)Constitution of the organization**

- (1)Articles of incorporation
- (2)By-laws

##### **c)Limited liability**

##### **d)Organization name**

#### **2.Formation**

##### **a)Creation of a nonprofit organization**

##### **b)Who may register**

#### **3.Governance**

##### **a)Rights and Duties of Members**

- (1)Classes of membership
- (2)Minimum and maximum membership
- 1.Transferability of membership
- (3)Restrictions on distributions to membership
- (4)Admission of members
- (5)Resignation, termination and discipline of membership
- (6)Members meetings
  - (a)Calling meetings
  - (b)Voting entitlements
- (7)Rights and remedies of members
  - (a)Rights of access to information
  - (b)Right to call meetings
- (8)Right to ask for investigation

##### **b)Rights and Duties of Directors**

- (1)Director's Duty to Manage
- (2)Delegation of Powers
- (3)Number of Directors
- (4)Term and Office
- (5)Meetings of Directors
- (6)Standards of Conduct
  - (a)Duty of prudence
  - (b)Duty of loyalty
  - (c)Duty of fairness (avoiding conflicts of interest)
- (7)Removal, Resignation and Vacancies

##### **c)Rights and Duties of Officers**

##### **d)Creditors**

##### **e)Auditors**

##### **f)Records**

##### **g)External supervision**

#### **4.Reorganization and Dissolution**



## VI. Should Lithuania Have Four or Only One Statute Dealing with Nonprofit Organizations?

A. As mentioned above, many jurisdictions have only one statute that allows for the registration of nonprofit organizations. Lithuania appears to have at least four separate statutes. I will briefly set out some of the characteristics of these statutes to illustrate some of the advantages of having only one statute. The characteristics of these organization in Lithuania have many similarities and it is not obvious what explains the differences.

### B. Present Lithuania Legal Personalities Available for Nonprofit Organizations

#### 1. Public Organizations

- a) A voluntary association of Lithuania citizens and foreigners permanently residing here.
- 1. Must be established “in order to satisfy and implement the common needs and goals of members.”
- b) In order to implement its goals it can “found enterprises.”
- c) If their activities are local they are registered by the municipal executive institution; if their activities are county wide they are registered by the county governor; if their activities are country wide they are registered by the Ministry of Justice.
- d) Financial activity of public organizations are supervised by state tax inspectorates, insofar as concerns tax payments.
- e) Upon a voluntary termination, the property of the organization shall be used according to the procedure established in the bylaws; if the organization is terminated by a court decision the assets “shall be used according to the procedure established by laws.”
- f) I am told that the legislation was intended for local membership associations and professional associations, but is frequently used by NGOs.

#### 2. Associations

- a) Described as a “voluntary union of legal and natural persons which performs managerial, economic, social, cultural, educational, and scientific research tasks and functions which are established by association members”
- b) “The association shall be a nonprofit organization. It cannot distribute a gained profit among its members.”
- c) Income sources of the association can include “profit of the enterprise established by the association.”
- d) “When liquidating the association its property and funds which are left after paying debts shall be used in accordance with the procedure established in the statute. Only initial contributions may be returned to its members.”

#### 3. Charity and Sponsorship Funds

- a) Described as “a nonprofit organization without a membership the purpose of activities whereof is dispensing of charity or (and) sponsoring science, culture, education, art, religion, sports, health care, social care and assistance, environmental protection and other areas specified in the Law on Charity and Sponsorship.”
- b) A nonprofit organization is defined as meaning “an entity possessing the rights or legal persons which has been set up in accordance with the procedures established by law and the purposes of activities whereof is not profit seeking.”
- c) “The fund may not dispense charity or sponsor or in any other way distribute income to the Fund’s founders, members or management bodies or employees except in cases where they are objects of financial aid as laid down in the Founder’s statutes.”
- 1. “The Fund shall have the right to apply part of charity and sponsorship funds to the following purposes:
  - (1) administration expenses and development of the Fund’s activities -

up to 20 percent of its annual income.

(2)for the establishment and development of enterprises belonging to the Fund - up to 50 percent of its annual income including the expenses specified in sub-par. 1 of this par.”

d)The Fund is prohibited from “engaging in commercial activities” and from “participating in political activities, sponsoring political parties.”

e)The Funds must keep records “of charity and sponsorship specifying the donors of charity and sponsors as well as the donees and the amount and purpose of charity and sponsorship.”

f)“The Funds shall conduct accounting, present financial accounting data to state institutions and pay taxes, their financial accounting activities shall be controlled.”

g)An examiner or auditor must be appointed by the founders to inspect the annual accounts of the Fund and report to the Board.

h)“When liquidating the Fund its property...must be conveyed to another Fund or Funds that pursue similar objectives...”

#### 4.Public Institutions

a)Described as “a non-profit organization founded...from the assets of partners (owners) engaged in social, educational, scientific, cultural, sport or any other analogous activities and public to the members of the community as regards to the services it provides.”

b)“A non-profit organization is an entity with the rights of a legal person...for a purpose other than profit-making. Its profits can not be distributed to its founders, members, partners (owners).”

c)It can “provide paid services, perform contractual work and set the costs thereof.”

d)The sources of funds of a public institution may be...”fees received for services and contract work.”

e)Upon a liquidation “the partners (owners) may have only their...part of the capital refunded to them...[any remaining property] shall be given over to another non-profit organization.”

f)“The partner (owner) of the public institution can be a natural or a legal person...”

g)I was told that this type of organization was originally intended for museums, hospitals and libraries.

C.I have not had time to go carefully through these statutes, however, aside from traditions and perhaps some political difficulties, there would appear to be no policy reason why all of these statutes should not combined into one statute dealing with the registration of non-profit organizations. Although they are labelled differently and in a different order, the various parts of the statutes corresponded fairly closely with the parts of the model nonprofit statute that I outlined above. Obviously, there are nuances that I would not be aware of with respect to each individual type of organization, however, these could presumably be accommodated within one statute.

Having four statutes creates problems both for NGOs and the government:

1.It makes it more difficult for NGOs to incorporate since they have to make a judgement about which one of these statutes is most appropriate for them. It is usually difficult enough, even for lawyers, to become familiar with one nonprofit registration statute, let alone four.

2.Since the statutes appear to have different limitations on the activities of NGOs, and different obligations on directors and officers, NGOs will shop for the statute that provides them with the most desirable treatment (from the point of view of the incorporators).

3.It makes it difficult to apply rules to NGOs in the nonprofit registration statutes that will confidently apply to all NGOs that apply for public benefit status.

4. Since some of these statutes allow organizations to incorporate with local governments, and with different departments of government, it presumably makes it difficult to develop uniform practices in the administration of the statutes and it presumably makes it difficult for the public to seek out the incorporating documents of NGOs.

D. It should be relatively easy to draft a nonprofit corporate statute that is flexible enough to accommodate every type of organization, but at the same time provide the members and the public protection from self-dealing and abuses of private power. From the brief notes I made about them above, a number of points of comparison might be made between the various nonprofit statutes in Lithuania:

- a) Two of these contemplated nonprofit organizations are membership organizations and two are not. However, whether a nonprofit organization has memberships or not is easily accommodated within one statute. If it does not have memberships, the membership provisions simply do not apply to it.
- b) Some of the statutes appear to deal exclusively with mutual benefit organizations and others with public benefit organizations, although I understand that the distinction is not strictly enforced. Again, a nonprofit statute can be drafted to accommodate both types of organizations.
- c) Some of the statutes appear to allow business activities and others do not. Again, all nonprofit organizations should be allowed to engage in business activities. What distinguished a nonprofit from a for-profit organization is that the nonprofit corporation has a principal purpose other than earning a profit and it cannot distribute its profits to members. Basically, it cannot have shareholders. However, it is usually good policy to allow it to engage at least in some commercial activities. See below.
- d) The place of registration for the various organizations appear to differ. There is much to be gained by having all nonprofit organizations register with the same government branch.
- e) The rules on termination differ. Clearly if an organization is a public benefit organization and has benefited from tax concession, upon termination the property should have to be distributed to other public benefit organizations.
- f) The rules applying to Charity and Sponsorship Funds have a constraint on administrative costs - they cannot exceed 20 percent of sponsorships. This should apply to all or none of the organizations or a similar limitation should be found in the rules dealing exclusively with public benefit organizations. See the discussion of disbursements quotas below.
- g) Only three of the statutes have the traditional constraint found in nonprofit organization legislation, namely that profits cannot be distributed to members.
- h) I did not compare the rules relating to the liability of directors in the various statutes, but again arguably the same rules should apply to all nonprofit corporations. The law should clearly provide that the officers and directors of an NGO have a duty to exercise loyalty to the organization, to execute their responsibilities to the organization with care and diligence, and to maintain the confidentiality of nonpublic information about the organization. As an aside from any legal issue – one of the most important governance features of a public benefit organization is the board of directors. They are responsible for developing codes of conduct for themselves and members, approving a budget that reflects the organization's priorities, monitoring and controlling expenditures, approving annual reports, ensuring that the staff is being appropriately managed, ensuring that all members and employees understand their legal and ethical responsibilities, and so on. A good deal of training is required before someone can be an effective director of a public benefit organization. Ensuring that organizations realize the importance of effective stewardship is one of the important roles of intermediary associations. See

below.

i) Finally, none of the statutes contain rules explicitly dealing with self-dealing. To ensure fair dealing between members, in addition to rules prohibiting the distribution of profits, these statutes sometimes have rules explicitly prohibiting any member gaining a private benefit and rules prohibiting self-dealing (to prevent conflicts of interest) (or a rule that provides that if members do deal with the organisation they must do so at arm's length and for fair market value). These rules are not strictly needed in a nonprofit organization statute since members can rely upon the general law to prevent other members from, in effect, stealing from the organization, however, sometimes the self-dealing rules in the statute are stricter than the general law would require to ensure not only fairness between members but also the perception of fairness.

## **VII. How Should Nonprofit Organizations Be Taxed?**

### **A. Tax Treatment of Non-Profit Corporations**

1. In Lithuania the income of nonprofit corporations - other than that received as sponsorship - is taxed at a rate of 5 percent (or at the normal corporate rate?). In Canada, the income of non-profits is exempt from tax. The reason such income is not taxed as income in Canada is that it is not technically "taxable income." Theoretically, income is usually conceived of as the value of an individual's consumption in a year plus the increase in their net worth. Therefore, in this sense, it is clear that nonprofit organizations cannot have income and should not be taxed: They are defined explicitly to preclude a personal benefit to some individual and to prevent the distribution of profits. That is, unlike for-profit corporations, they are not owned by anyone. Obviously, this tax treatment reflects a policy judgement about which reasonable people can differ.

2. In Canada, all nonprofit corporations are exempt from tax and, therefore, normally they do not have to file tax returns. However, if the organization receives more than \$10,000 of investment income, or has assets in excess of \$200,000, then it must file an annual return. Also, if the tax department is concerned about abuses, it has the authority to require a nonprofit corporation to file an information return. The purpose of these rules is to allow nonprofit organizations to earn a small profit and not have to worry about filing a tax return, but once the organization is over a certain size, Revenue Canada insists that it file a return. Even though it is not taxable, in this way Revenue Canada can continue to monitor the organization to ensure that it is not conducting a business for the sole purpose of earning a profit.

3. In some jurisdictions, even though they are otherwise exempt from tax, non-profits have to pay tax on investment income (over a small amount).

4. Non-profits, generally, cannot issue tax deductible receipts for donations. That is, people who contribute to nonprofit corporations receive no special tax concession. In order to receive a tax deduction, a donor must contribute to a nonprofit corporation that is also registered as a public benefit organization (in Canada, referred to as a charity).

5. Although I am not sure I understand the law very well, if Lithuania continues to tax the income of non-profits, perhaps it should consider exempting income under a certain amount and in this way spare small non-profit organizations the trouble of having to file a tax return.

**VIII. To Repeat the Question Asked Above, Should an Organization Have to Register as Non-Profit Organization Before It Can Apply for Registration as a Public Benefit Organization?**

A. Now to answer the original question: should an organization have to register as a non-profit organization before it can apply for registration as a public benefit organization? The answer should be - I think - yes.

1. The reasons why an organization should have to register as a non-profit organization include the need for the organization to be able to contract and hold property in its own name; so that it can limit the liability of its members; so that it can be held responsible to its employees; and to ensure that the laws that apply generally to nonprofit organizations apply to public benefit organizations, such as rules ensuring that no private benefit is obtained from its activities. Moreover, all of the rules of governance that apply to nonprofit organizations generally should clearly also apply to public benefit organizations.

2. The procedure for incorporation (or registration) as a nonprofit corporation should be relatively quick, easy and inexpensive

3. The administration of nonprofit corporations might be centralized to ensure uniformity in the application of the law and to ensure that the public can gain easy access to a nonprofit organization's governing documents.

4. However, since, unlike other nonprofit organizations, nonprofit organizations that also want to be public benefit organizations will be receiving implicit tax subsidies from the government, and perhaps even direct subsidies, there has to be another set of rules that apply to them ensuring that they have to file regular financial and other information, ensuring that they are continuing to engage in public benefit activities, ensuring that they do not engage in prohibited activities and generally ensuring they are held accountable for the government tax subsidies that they receive. See outline of model public benefit statute below.

### III. Definition of a Public Benefit Organization

#### IX. How Should a Public Benefit Activity Be Defined?

A. General policy - "Doing good for the benefit of others"

B. "Public benefit" activities should have two essential characteristics

1. The activity involves a benefit (the benefit test). This test really has two parts
  - a) The activity must involve the pursuit of a objective that will be a benefit
  - b) The method chosen to pursue this objective must have some utility
2. The public - and not the donors to or members of the organization (except as members of the public) - must benefit (the public test)

C. Instead of stating these two principles (or some other set of principles) that underlie the public benefit test, most countries simply list the activities that might prima facie be public benefit activities and then rely upon argument by analogy to extend the list. An informed process of appeal from the initial agency's decision about whether a particular activity is a public benefit will eventually result in a body of precedent that will give a degree of certainty to which activities are considered public benefits activities. To ensure that arguments by analogy are acceptable, the illustrative list is usually followed by a residual clause such as "or any other activity that provides a public benefit."

D. In view of the incredibly large diversity of activities that might be in the public benefit, it would seem to make sense to state the items contained in the list at a fairly high level of generality. So, for example, the list might provide: "Public benefit activities include activities in the fields of social services; education and research; culture and the arts; religion; health; environment; human rights; crime prevention, public safety and preservation of law and order; consumer protection; the promotion of tolerance and understanding; and, any other activity that provides a public benefit."

E. Then, to provide more concrete illustrations of what activities might amount to public benefit activities, each of these major headings could be subdivided in regulations to the statute or in the form that is used by nonprofit organization in applying for public benefit status. ( In any event, for policy planning purposes, it will be important to be able to categorize relatively precisely what activities each NGO is engaged in.) There are several comprehensive attempts at classifying the activities of nonprofit organizations. A categorization suitable for Lithuania might be drawn up by relying upon the United Nations classification, the classification by the ICNPO, or the international classification of nonprofit organizations prepared by the Johns Hopkins Comparative Nonprofit Sector Project.

F. Simply by way of illustration, in Canada, in order to classify the work done by particular NGOs, the broad heading "Social Services" is subdivided into (1) housing for seniors, low-income people, and those with disabilities, (2) food and clothing banks, soup kitchens, hostels, (3) employment preparation and training, (4) legal assistance and services, (5) other services for low-income people, (6) senior's services, (7) services for the physically or mentally challenged, (8) children and youth services, (9) services for aboriginal people, (10) emergency shelter, (11) family and crises counselling, financial counselling, (12) immigration aid, (13) rehabilitation of offenders, (14) disaster relief. Each major heading is similarly divided up and each public benefit organization has to estimate how much of their resources is devoted to each specific activity. The complete list obviously provides a good indication of what is regarded as a public benefit activity as well as providing the government and other agencies with important information about the types of services being performed in the community by NGOs.

G. The list of activities provided in Article 3(3) of the draft provides a useful list of activities and is well drafted. I have only three minor comments: (1) It might be modified slightly to more closely

conform to the fields identified by international agencies. (2) Specific activities - such as “adaptation of residential areas and the construction of residential housing” - might either be taken off the list or qualified by a phrase such as “only if it is undertaken primarily for the benefit of disadvantaged individuals or groups.” The public does not derive much benefit from the construction of luxury residential accommodation, for example. (3) As an incidental matter, “sports” is not considered a public benefit activity in Canada unless the donation is given to the national sports body. If each local soccer, baseball, basketball, figure skating and hockey club could register as a charity they all would (in Canada) and parents would essentially be able to deduct from their taxes amounts paid to have their children join these clubs. Of course the tax department could argue that these local clubs are not engaged in public benefit activities because they are not providing a “public” benefit or they could try to distinguish between a donation and a fee to join the club, but such distinctions would be extremely difficult (but not impossible) to administer.

H. At the very least for political reasons, I presume, no one is going to seriously argue that religion should not be a legitimate activity for a public benefit organization. However, it is worth noting that admitting it as public benefit activity poses special problems, and some countries (like Australia and others) do not provide tax concessions for religious organizations. Just for the record, I simply list here a few of the reasons why religion poses special problems if it is designated as a public benefit activity and caution that at the very least care must be taken so that admitting it does not divert substantial resources from other organizations:

1. The difficulty of determining what types of activities qualify, particularly if there is no inquiry into the “validity” of a religious purpose.
2. Amounts given to religion are not gifts, they are more in the nature of membership fees
3. Since donations to churches are given out of a sense of religious responsibility they do not require any special incentive
4. Allowing a tax concession forces those who do not belong to organized religions to subsidize those who do
5. Churches already receive enormous state subsidization through concessions in real property taxes and so on
6. In countries that allow religions to qualify as public benefit organizations they receive over 50 percent of the implicit government subsidy
7. Arguably churches do not foster the development of civil society, as that term is used by sociologists, or necessarily foster values important for a vibrant democracy
8. Perhaps a concession should only be given for that percentage of the churches’ monies that are spent on the relief of poverty and assistance to the vulnerable

**X. Should there be a Distinction Between Activities Relating to Helping the Poor and Vulnerable (charity donees) and Activities Relating to Other Public Benefits (sponsorship donees)?**

A. The draft makes a distinction between charity donees and sponsorship donees. I understand the historical and institutional reasons for drawing the distinction, however, I would only make the general point that the legislation could be considerably simplified if it were dropped. If the main reason for it is that charity donees do not pay tax on cash received from sponsorship donees than this provision could be found in the income tax act without the need to define it in this statute.

B. One might argue that the helping the poor is more urgent and, therefore, should be given even more generous preferential tax treatment than other public benefit activities. Presumably all other requirements should be the same. However, this distinction is often hard to draw, for example, many donations for the advancement of education and health or for the support of the elderly are donations for the relief of poverty. Moreover, arguably the greater needs of the poor and vulnerable should be reflected in government spending.

**XI. How Should a Public Benefit Organization Be Defined?**

- A. In light of the above considerations, a public benefit organization might be defined simply as:  
 “The (relevant government department ) will register as a public benefit organization any organization that is
- a) registered as a nonprofit corporation; and
  - b) organized and operated principally (exclusively) to engage in one or more public benefits activities.

**XII. What Tax Treatment Should Public Benefit Organizations Receive?**

- A. Income should be exempt from tax (see below for related business income and other miscellaneous sources of income)
- B. Donors should receive preferential tax treatment (see below)

**XIII. What Other Advantages Are There For an Organization to Become Registered as a Public Benefit Organization?**

- A. Since public benefit organizations are subject to considerable control and oversight and have to disclose annual statements, many government grants, including the proceeds of lotteries, for example, are often only available to organizations registered as public benefit organizations.
- B. Often only public benefit organizations can engage in certain types of fund-raising, such as lotteries.
- C. The credibility that goes with being a registered public benefit organization assists such organizations in collecting money from the public.

## IV. Process

### for Registering and Overseeing Public Benefit Organizations

**XIV. Which Government Department Should Register, Oversight and Sanction Public Benefit Organizations?**

- A. Should a division of the tax department; justice department; corporate department; or a special commission be responsible for registering public benefit organizations?
- B. Criteria for selecting the government division that acts as an oversight body for public benefit organizations:
1. The division should be independent from NGOs - it must not be vulnerable to the influence of NGOs (through personnel exchanges, for example), and it must have some incentive not to register every NGO, for example, because of a concern over government revenues.
  1. If the division is in some government department, for example the tax department, it should be constituted as a special division, employees should be given special training and so on. NGOs are sometimes concerned that if the oversight function is given to the tax department its employees will bring to bear the attitude of tax collectors to their work. However, this will not necessarily be the case if the division is established as a special unit within the tax department and if they are given special training.
  2. Employees will usually be required to have a background knowledge of accounting and auditing skills
  3. The division will require the powers of search and seizure and the other powers traditionally associated with collecting taxes. For example, the supervising agency should



have the right to examine the books, records and activities of an NGO during ordinary business hours.

4.The division should be centralised to ensure uniformity of enforcement across all types of NGOs and regions of the country

5.The division should be one that has the capacity to interpret the law and adjudicate disputes. NGOs sometimes complain that the staff of the tax department (for example) are unfamiliar and generally have no personal experience with civil society. But this complaint misconceives the role of an oversight agency. Its role is to administer the law and adjudicate disputes according to the law not act as cheer leader for NGOs (this role should be that of another government department - see below)..

C.In Canada, Australia and the United States the overseeing regulatory body is a special division within the revenue department. In the UK a separate charity commission has responsibility for all aspects of charities. Applying the criteria above, my suggestion would be that the appropriate division is a special unit within the tax department.

D.Most charitable divisions within tax departments complain that: they have insufficient resources to audit all but a small percentage of charities and that the positions in the charity division of the tax department tend to be relatively junior and therefore low paying and therefore personnel often attempt to acquire promotions to other divisions within the tax department - obviously it is important to attempt to overcome these problems.

E.If the oversight division is within a government department, then the government should consider establishing another unit within government to provide advice to, encourage and assist, facilitate public information, aid in the registration process, and help public benefit organizations in all aspect of compliance with the regulations that govern them. One reason for establishing a separate division in government for these functions is that public benefit organizations might be reluctant to approach the tax department for advice fearing they might not get biased advice or that they will be subject to an audit. See below.

F.I understand that the draft contemplates that one division of government will register public benefit organizations but that the tax department will conduct the ongoing monitoring. Again, it is easy to understand the politics of this, but it seems to lead to needless expense. Two government divisions will have to become experts in the nature of public benefits activities. Moreover, it could lead to the somewhat embarrassing situation of the one division registering an organization as a public benefit organization and then the next year the tax department deregistering it on the basis of its annual filings because it does not think it is engaged in public benefit activities. It would certainly be more convenient to require registration with the tax department, and then to ensure that its decisions were not biased, to provide a simple appeal process from them. And in any event, whatever government division registers organizations there should be a simply appeal process from their decisions.

#### **XV.What Should the Appeals Process Be for Refusal to Register or for Inappropriate Oversight or Improper Sanctions?**

A.The initial decision to register an organization as a public benefit organisation must normally be done simply on the basis of the information the organization provides the division (see below). There is no oral hearing. In Canada, in about one-quarter of the cases the Revenue Department has to ask for additional information because the application was incomplete or because the statement of purposes was not sufficiently detailed.

B.The applicant should be entitled to be informed within some reasonable time period as to whether its application has been accepted or rejected. On the one hand, this period of time should not be so short that the oversight committee simply ends up rubber stamping applications; but, on

the other hand, it should not be so long that the NGO becomes discouraged and cannot get on with its work. In Canada the statutory period is 6 months, but registration normally takes only about 4 months. Many NGOs claim that even this is too long a period and would prefer a rule that required the department to respond to them within only a 3 month period.

C.If the oversight division has not notified the applicant of its decision within (6 months - or whatever period is acceptable) the application should be deemed to be acceptable (this would place pressure on the oversight division to discharge its responsibilities efficiently) (or, accepting the inevitability of under staffing - the application should be deemed to have been rejected - this is the law in Canada, but NGOs complain about it - it is not a big problem because normally the department gives its decision to register or not within four months).

D.Every year, (and perhaps more frequently in the form of a monthly bulletin or reporter service) the oversight division should prepare a report setting out the number of applications accepted, the number of applications rejected, the number of registration revoked, and so on, and the reasons given. Also it should provide an assessment of the reasons for denying applications and policy guidance for how it is exercising its adjudicative responsibilities. (It is important that the process be as transparent as possible.)

E.The first step in an appeal from the decision of the oversight division should be to some form of administrative tribunal perhaps composed of members drawn both from government and from a relevant NGO umbrella organization. Also, other interested parties should have the ability to intervene in this hearing. The reasons for allowing an appeal to an administrative tribunal is that the decision as to whether an organization is a public benefit organization is both a legal and policy issue.

F.A second appeal should be allowed to a Court.

G.It is not clear from the draft (that I have) who will hear the initial applications for registration, the time periods for a response, or the process of appeal. I assume this will either be covered in regulations or is in other statutes.

#### **XVI.What Documents Should Have to be Filed and Information Provided to Obtain a Registration Number as a Public Benefit Organization (the Registration Process)?**

A.The following four types of information must be filed by an organization when applying for public benefit organization status in Canada.

##### **1. Application Form**

- a)Identification of applicant (address, phone number, and so on)
- b)List of directors
- c)Organizational structure
- d)Description of organization's activities and how it intends to achieve its purposes
- e)Methods of fundraising
- f)Proposed budget

(All of the above is public information in Canada. In addition, as confidential information, the organization is required to give the names, addresses and phone numbers of the directors; business address and physical location of the organization; and the physical location of books and records.)

2.Certified copy of each of the public benefit organization's founding documents (articles of incorporation and by-laws)

1.Financial statements of prior years or detailed budget of upcoming year.

3.A copy of minutes, newspaper clippings, pamphlets, fund-raising materials and so on.

### **XVII. Should NGOs in Existence at the Time of the Enactment of New Laws Have to Apply for Registration?**

A. When the new law in Lithuania comes into effect there will presumably be thousands of NGOs waiting to be registered. Obviously their applications will not be able to be vetted very carefully and a registration number will undoubtedly be issued to them as a matter of course. Indeed, it would not be unreasonable if the government was given, say 6 months, from the date of application to issue new registration number to applicants. Nevertheless, for a number of reasons it would appear sensible to require them to apply for a new registration number:

1. Requiring them to apply under the new law will alert them to the new rules, new obligations, and new responsibilities and privileges
2. Moreover, it will be a small inconvenience for them since most of the information they will be required to submit will be required in their first annual filings at any rate.
3. If any organization applies and clearly does not qualify at least its representations will be on the record and the organization, and its directors, can later be held liable for fines and penalties.

## **V. Requirements to File Documents and Disclose Information**

### **XVIII. What Periodical Reporting Requirements Should Be Imposed Upon Public Benefit Organizations?**

#### **A. Information returns**

1. Clearly organizations have to be required to periodically file returns so that the organization's public benefit activities can be audited and to ensure that none of the rules relating to prohibitions on private benefits, or limitations on its activities, and so on, have been violated. But also information should be collected from each public benefit organization so that it can be used for purposes of statistical analysis and public policy planning

#### **B. Information required in Canada to be filed periodically (annually) by charities:**

- a) Charities name, address, tax number and period which the return documents
- b) Name, address and position of charities directors and relationship to one another
- c) A description of programmes undertaken during the relevant period, including a requirement that the activities be coded, that is, that the organization estimate how much of its efforts were devoted to which of over 100 listed areas.
- d) Financial information (the organization must also file its own financial statements, which may use a different bookkeeping method than that required in the form).
  - (1) Statement of assets and liabilities
  - (2) Statement of receipts and disbursements
- e) Information about fund-raising methods
- f) Remuneration and benefits paid to the highest (five) paid managers and directors
- g) Questions about whether any family members received payments or loans or whether property had been transferred to founders, trustees or members
- h) Political activities
- i) Gifts to qualified donees
- j) Expenditures on programs outside the country

(In Canada all of the above information is made public. The following information, which is also collected, is confidential - a checklist to ensure the organization has met the guidelines for issuing receipts and receiving donations; a listing or property held; information relevant to whether the organization's disbursement quota has been met.)

### **XIX. Should There Be Separate Reporting Requirements for Large and Small Public Benefit**

**Organizations?**

A. In small public benefit organizations the reporting requirements can be very onerous, particularly if it means that an accountant or lawyer has to be hired in order to assist the organization. Moreover, the potentials for abuse are not as great in small organizations as they are in large organizations. Therefore, it seems quite reasonable to require separate reporting requirements for small and large organizations. The following suggestions are intended to be illustrative

B. A small public benefit organization (one that has an annual operating budget under some appropriate amount) should have to file only the following information every year (in addition to basic information about the organization and directors):

1. Description of the organization's mission, programs and intended results
2. Financial statements as approved by the board
3. Description of fundraising activities over the past year including amount of revenues raised and the amount spent raising them
4. Description of basic governance structure, including size of board and methods for selecting board members
5. Disclosure of the code of ethical fundraising to which the organization adheres
1. Description of the organization's approach to responding to complaints
6. How to get further information directly from the organization

C. A larger organization should have to file, in addition:

1. The nature of the mission, intended outcomes and strategic planning processes
2. Overview of policy of transparency, including information on the organization's code of ethical conduct and complaints process, and the number of board meetings for the past year
3. Description of governing structures, including whether an independent nominating and an audit committee exists
4. Summary of methods of board stewardship (oversight of the organizations activities)
5. Evidence of fiscal responsibility, through provision of audited financial statements
6. Methods for board succession and diversity of representation

D. Most of the reporting requirements under the draft legislation will be imposed by regulation it appears, therefore, I am not sure exactly what they will be. However, I might just comment on one provision. Article 12(2) requires public benefit organizations to prepare accounts that "identify the donors of received sponsorship...the value, and the use of the received sponsorship donation (specifying the individual donees...)." This would seem to require a very detailed reporting. Under the Canadian system the charity only reports on its activities generally. The way that individual donations are kept track of, and verified, is simply by requiring the charity to retain all of their receipts. That is, if an individual claims a deduction for a donation to a charity on their tax return, they have to file a copy of the official receipt with their tax return. The charity itself must keep on record another copy of the receipt (it must keep on file a copy of all receipts it issues). Each official donation receipt must contain the following information: a statement that it is an official receipt for income tax purposes; the charities registration number; the serial number of the receipt; the place where it was issued; the date; the amount of the donation; the signature of the individual authorized by the charity to issue receipts. Other than this receipt, the individual donor's name and donation would not be a matter of record. However, by requiring the charities registration number and a serial number to appear on the receipt it is relatively easy for the tax department to match up claimed donations with actual receipts by charities.

**XX. How Often Should Reporting Be Required?**

A. Quarterly or annually

1.The draft requires organizations to report quarterly. Quarterly reports obviously require an organization to turn its attention to its activities at least every three months, which is not necessarily a bad thing, but requiring quarterly reports would appear to be onerous and if they are not going to be audited a needless requirement. Annual reporting would appear to be sufficient. Moreover, most organizations would only prepare their financial statements once a year.

B.The draft requires an annual report but again precisely what has to be included in the report is left to regulations. I assume that the annual report must be made on a calendar year basis. (In Canada it can be filed on a fiscal year basis - but this leads to problems.) In Canada the organization has to file its annual report within 6 months of the end of the calendar year (or the organization's fiscal year).

#### **XXI.Should Donors Be Required to Report Their Donations?**

A.The draft in Article 12(1) requires donors to file quarterly reports of their donations. This would appear to be a needless requirement. When auditing a donor the only relevant question is whether the donor made a donation to a public benefit organization and is therefore entitled to some form of tax benefit. If the donor is required to retain the receipt (with serial number and the public benefit organization's registered number) this would appear to be adequate proof of a donation. It is only by auditing the organisation itself that revenue officials can determine the use that was made of the donation. Also, for statistical purposes, information about donations by particular groups of taxpayers can easily be determined from tax return or tax withholding information.

#### **XXII.Which Documents Filed by a Public Benefit Organization Should be Available for Public Inspection?**

A.Basically, all documents that are required to be filed should be publicly available both at the government division that oversees public benefit organizations and at the office of each individual organization. As resources permit, all documents (at least for large organizations) should be required to be filed electronically and be available on the internet. Making information about public benefit organizations readily accessible to the public is one of the most efficient ways of preventing improper conduct on the part of the organizations. It promotes self-regulation and gives the public confidence in the sector. It also encourages individuals to become better informed about the role of public benefit organizations.

B.In Canada, some filed information is kept confidential, see above, but it should not be and it is a frequent complaint (by the public) about the system.

C.Special case of churches

D.In addition to making their information returns to the tax department public, at least NGOs over a certain size might also be required to make a summary annual report available to the public. I am not sure if this is what was intended by the requirement in Article 12(3) of the draft.

#### **XXIII.What Obligations Should There Be on Public Benefit Organizations to Retain Records?**

A.Public benefit organizations should be subject to the same record retention requirements as ordinary businesses. This presumably means that they should keep official donation receipts, records of their income and expenditures, and so on at an address known to the tax department. In addition, they should be required to keep information from which the tax department can verify that the organization's activities were for the public benefit. Although this information might vary from organization to organization presumably it should include the minutes of meetings, correspondence, publicity brochures, and advertisements. In Canada these records must be kept for

a minimum of six years.

## VI. Limitations on Activities of Public Benefit Organizations

### XXIV. Should there be Limitations on Business Activities?

A. There are two questions in relation to business activities carried on by public benefit organizations: (1) What types of business activities, if any, should they be allowed to conduct? (2) If they conduct permissible business activities, how should the income be taxed, if at all? (Upon reflection, it might be clearer if these activities were referred to as commercial activities instead of business activities. In that way, one could say that public benefit organizations cannot be formed to carry on a business, but they can engage in some commercial activities.)

B. I take it that the present position in Lithuania is that most nonprofit organizations are allowed to carry on business activities (at least the legislation would appear to permit them to) but that Sponsorship and Charity Funds are specifically prohibited from carrying on business activities. If nonprofit organizations carry on business activities, their income is taxed at a rate of 5% (or the normal business rate?). The position with relation to Funds is an extreme position. In many jurisdictions, public benefit organizations are allowed to earn business income, within limits, and when they do it is exempt from tax. There are basically six positions alternative positions that countries might take. As set out below, these positions range along a continuum from allowing and exempting only business income that is an integral part of the organization's activities to exempting all business income so long as it is used for public benefit activities.

C. Allowable business activities (six possible positions - from the most restrictive to the most liberal):

#### 1. Prohibit

a) Prohibit all business activities and tax at full rates any business income that is earned (and perhaps a penalty as well)

b) As mentioned above, this is an extreme position. At the very least, public benefit organizations often earn business income as an integral part of their public benefit activities and since the income earned is used for public benefit purposes it should be exempt from tax.

#### 2. Ancillary or Incidental Businesses

a) Allow business activities that are an integral part of the public benefit organization's activities (or that are ancillary or complimentary to the operation of the organization) and exempt the amount from tax.

b) In most countries, income earned from these types of business activities are allowed and are exempt from tax.

1. Examples would include a society for the blind that sells white canes, a museum that charges an entrance fee, a ballet company that charges admission to its performances, a college that charges a tuition, an amount paid for using the parking lot of a hospital.

#### 3. Irregular Business Activity

a) In addition to businesses that are an integral part of the public benefit activities, some jurisdictions allow business activities that are conducted on an irregular or occasional basis and exempt the income from tax. Among other things, this allows public benefit organizations to engage in their own commercial fund-raising activities.

b) Examples would include raffles and charity auctions that might be held from time to time by an NGO, sale of recordings by a symphony orchestra, sale of posters by a ballet company and so on.

c) In applying this general principle, some tax departments have a general rule that so long as a substantial part of the employment (say 90 percent) of the business activity is undertaken by volunteers, the business activity will be

allowed and the income exempt from tax.

#### 4.Related Business Activities

a)The tax treatment of these business activities varies greatly from country to country. In Canada, related business activities are allowed and not taxed.

b)Examples - A literary organization holds a book fair, or an NGO that sells a magazine related to its principal public benefit activities, the church bookstore, the hospital that charges for a semi-private room, the organization that helps the unemployed by using them in some way for the provision of services for which they charge.

c)Criteria for determining whether the business is related to the public benefit activities include:

(1)Whether the business extends, promotes, or supplements the organization's public benefit activities

(2)Whether it involves substantial voluntary labour

(3)Whether it uses specialized expertise developed in the course of the charitable work

(4)Relationship of the activity to the charities goals

(5)The profit motive of the charity

(6)The extent to which the business operation competes with for-profit enterprises

(7)The length of time the activity is carried on

d)In some jurisdictions, unrelated business activities are allowed but taxed at the normal corporate tax rate. Here is an illustrative draft provision: "Unrelated business"

(1)An unrelated business of a public benefit organization shall be treated as a separate entity taxable under..(the relevant charging provision) on its unrelated business taxable income

(2)The terms "unrelated business" means any business the conduct of which is not substantially related to the exercise or performance by such organization of its public benefit activities"

#### 5.Principal purpose test

a)Some jurisdictions exempt income from a business activity of an NGO so long as it is not the principal purpose of the organization

b)A bright-line test is sometimes used to determine whether the business is the principal purpose of the NGO, for example, if more than 50 percent of the revenues and expenditures of an NGO are attributable to economic activities for a significant period of time (for example, 3 years) the organization is classified not as an NGO but as a taxable business entity.

#### 6.Destination of income test.

a)The most generous test, from the point of view of the NGO, is the destination of income test. Under this test, the income of business activity is not taxed so long as it is used for carrying out the public benefit activities of the NGO.

7.The amount of business activities to allow an NGO to carry on without paying tax is a complex question but involves weighing considerations such as the following:

a)On the one hand, business activities can prove to be an important source of revenue for NGOs; the special expertise of their members means that the business activities can closely compliment their public benefit activities

b)On the other hand, if NGOs are widely engaged in business activities it creates unfair competition for private entrepreneurs; it might cause the public to be more cynical of the public benefit activities of NGOs generally; and, to the extent that the business activities are risky they might draw on money that should be available for public benefit purposes.

c)Balancing these various interests might lead to a rule that would exempt related



business activity income from tax and allow (but tax) business income so long as the business activity is not the principal purpose of the NGO.

d) I would have thought that in countries anxious to establish NGOs that there would be a strong case for imposing a test that provided NGOs with a substantial amount of freedom to engage in business activities and exempt the income from tax. It could be an important source of revenue for public benefit activities. Moreover, in these days of preoccupation with international competitiveness, perhaps there is an argument to be made that entrepreneurial talent should be encouraged where ever it is found.

e) Another rule that nicely balances the need for public benefit organizations to earn income and the danger that they will provide unfair competition to for-profit businesses is a rule that would require public benefit organizations which are engaging in substantial business activities to form a separate for-profit corporation to carry on the business. Then, so long as the public benefit organization owned 100 percent of the shares of the corporation, the corporation should be permitted to deduct without limit, in any given taxation year, its donations to the parent public benefit organization. In this way, the public benefit organization is able to earn income, yet the business is not able to benefit from tax exempt earnings. If earnings are plowed back into the business, they will be taxed.

## **XXV. Should There Be Limitations on Investment Activities?**

A. Generally, investment activities should be permitted and the income from it not taxed on the argument that investing donations to generate income for future public benefit activities should be encouraged. Nevertheless, obviously the investment activity would have to be incidental to the public benefit activity or the organization would not be operated “exclusively” or “primarily” for public benefit activities. Also, the organization should be required to meet its disbursement quota every year - if there is one.

B. Nevertheless, there are three reasons why governments might want to regulate the investment activities of public benefit organizations.

1. One is to ensure that the organizations assets remain available over the long term to do public benefit work. In many jurisdictions this is done by ensuring that only sound investment decisions are made by the public benefit organization’s board of directors. This objective is generally achieved through imposition of investment guidelines or investment restrictions on directors. For example, they are only allowed to invest in shares and bonds of so-called blue-chip companies. I will not say more about this reason for regulating investment activities — legislative models are readily available should such rules be deemed desirable.

2. A second reason to regulate the investment activity of charities is to prevent the investment activity from becoming an end in itself and to prevent the investing public benefit organization from being transformed thereby into an investment business. This is best regulated simply by resorting to the “exclusively public benefit activities” standard if an organization appears to have become simply an investment company and deregistering it and perhaps imposing penalties.

3. A third reason to control the investment activity of public benefit organizations is to prevent the individuals involved in the organization from profiting from their relationship to the organization - either personally or through benefits to their families, companies, or associates - or, more generally, to prevent the public benefit organization from becoming a front for the profit-making activity of the individuals behind the public benefit organization. The simplest way founders might abuse a public benefit organization is by loaning the public benefit organizations assets to a related individual or by investing its assets in shares of the companies controlled by those persons. This third reason to control

the investment activity of public benefit organization clearly requires some special rules. I am not familiar with the rules that at present govern this kind of activity in Lithuania, but let me suggest the following model. Since this is a general problem - that is it is a concern whether the public benefit organization is paying a salary to a person related to the organization or loaning them money - the rules should apply more generally than to investments.

4. The following are some guidelines for a regime of rules regulating investment, business and other contractual transactions between persons in some way related to the public benefit organization (members, directors, officers and members of their families) and the organization itself:

- a) The rules should apply to all types of transactions in which value is transferred between members of the related class and the organization. A definition, perhaps together with a non-exclusive list of the main transactions (sales, leases, loans, contracts of employment or for services and so on), is required.
- b) These transactions should be prohibited unless they are approved by the board of directors and they are fair and reasonable to the organization.
- c) Breaches of this rule should result in sanctions to the organization, to the individuals involved in the offending transactions, and to the board of directors of the organization who approved the transaction. In appropriate cases, breaches should be penalized with deregistration.
- d) To ensure that the non-complying transactions come to the attention of the government oversight authority, there should be an obligation on the organization to report the material provisions of all transactions between members of the related class and the organization in which value is transferred. There should be an endorsement by the directors in the report that the transaction meets the fair and reasonable standard.
- e) In any administrative or judicial proceeding where there is a question whether a transaction is complying or not, the burden of proving that it complies should be on the persons alleging that it does.
- f) Finally, there might be a bright-line test that prohibits the organization from investing or loaning more than 10 percent of its assets to individuals, or in companies owned by those, who are in the class of related persons.

#### **XXVI. Should There Be Limitations on Political Activities?**

A. In Article 10(2)(1) the draft implicitly allows public benefit organisations to use their funds to engage in any political activity except “for propaganda and activities of political parties and political organizations or for funding election campaigns.” Since I think this is the correct position (so long as propaganda is understood to relate only to promoting political parties) I will say little about it. In some jurisdictions lobbying for legislative change and other types of political activities of public benefit organizations is prohibited or substantially curtailed. It is substantially curtailed in Canada, and it is an extremely contentious issue. This is the wrong position in principle and almost impossible to enforce fairly in practice. The arguments for some restrictions include the fact that political activities might divert the resources of public benefit organizations from their public benefit activities and impair the credibility of public benefit organizations among members of the public since they would be engaged in contentious issues. But, on the other hand, a vibrant democracy requires an opportunity for all voices to be heard; public benefit organizations likely have information useful to the public in assessing public policy issues; and, in many instances it is extremely difficult to distinguish between education and political activities.

## **VII. Requirement to Disburse a Certain Percentage of Income Each Year**

#### **XXVII. Should There Be a Requirement That the Organization Disburse a Certain Percentage of Its Income Each Year?**

A. Should the public benefit organization have to disburse a certain percentage of the donations it receives each year to ensure that it is not spending an excess amount on fund-raising and administrative costs and to ensure that it is not simply accumulating the donations it receives and not using the amounts immediately for their intended purpose?

B. Should there be a distinction between active public benefit organizations (organizations directly involved in public benefit activities) and foundations (organizations that have an endowment that is used to fund public benefit organizations)?

C. Public benefit organizations (Canadian rules)

1. Must disburse 80% of receipted donations from prior year. (What should be included in the amount subject to the disbursement quota - only receipted donations - government grants, business income, unreceipted donations, investment income, and so on? In Canada, it is only receipted donations.)

2. 100% of amounts received from other charities have to be disbursed.

3. The organization can apply to accumulate a capital fund for specific purposes

4. Donors can give amounts on condition they be held as an endowment for 10 years.

Should such a presumption apply if the amount is a bequest?

5. As can be imagined, these rules very quickly can become quite complex. Since the issue does not appear to be dealt with in the draft legislation, and since I am not sure if it is dealt with elsewhere, I will not deal with the rules in detail here.

D. Foundations

1. In many jurisdictions a clear distinction is made between public benefit organizations that are engaged directly in public benefit activities and public benefit organizations whose purpose is to hold investment assets (usually donated to it by a wealthy family or large corporation) and pay out grants to other public benefit organizations each year. These latter organizations are frequently referred to as foundations. In Canada, and particularly in the United States, much of the criticisms of charities has centered around the role and regulation of foundations. Again, since the draft legislation does not appear to deal with this issue, I will not deal with it in detail here.

2. In Canada, the basic disbursement rules that applies to foundations is that each year they must disburse 4.5% of the average value of their assets over the year.

## VIII. Tax Concessions for Public Benefit Organizations

### XXVIII. What Form Should Income Tax Relief Take for Persons Who Donate to Public Benefit Organizations?

A. Generic Form - A Matching Grant System

1. All forms of tax relief to donors should be conceptualized as simply a form of government matching grants for private donations. That is, if the government provides a 50% tax credit for donations, then, in effect, the government has undertaken to pay the same amount to a public benefit organization as the taxpayer does. If a taxpayer donates \$100 they have, in effect, donated \$50 of their own money and \$50 of the government. The government reimburses donors for its share by allowing donors to claim the tax credit when they file their tax return.

B. Tax deduction

1. The distinction between a tax deduction and a tax credit is really only important if the tax system has progressive rates. If the rate is flat then a tax deduction is equivalent to a tax credit at the basic rate of tax.

2. An illustrative tax provision providing for a tax deduction might be: “There shall be allowed as a tax deduction any contribution made by the taxpayer during the year to a public benefit organization within the allowable amount set forth (in the next subsection.)”

3. Under this form of matching grant (used in the United States and some other countries), taxpayers are allowed to deduct their contributions to public benefit organizations from their income for tax purposes. Thus, implicitly, the federal government’s matching grant depends upon the taxpayer’s marginal tax rate. Assuming that tax rates are progressive, this means that high-income individuals are able to obtain a larger matching grant than lower-income taxpayers. This makes no sense.

#### C. Double deduction

1. Under this matching grant scheme, the taxpayer is able to deduct twice the amount contributed to public benefit organizations. It is simply an enriched version of a tax deduction and shares all of its problems. Although it is more generous, it is slightly more complicated.

#### D. Tax credit

1. An illustrative provision for a tax credit might be: “There shall be allowed as a credit against tax owing (50%) of any contribution made by the taxpayer during the year to a public benefit organization within the allowable amount set forth (in the next subsection)”

2. Under this form of matching grant (used in Canada and some other countries), taxpayers are allowed to deduct some percentage of their contributions to public benefit organizations from their tax payable. This means that all taxpayers receive the same matching grant for equal amounts given. However, if a person is too poor to owe any income tax, then they are not able to allocate government funds to public benefit organizations.

#### E. Withholding system

1. Under an employer tax withholding system presumably both a tax deduction and credit could be used, but it would require filing receipts with the employer so that the appropriate adjustment could be made to the employee’s withholding rate.

#### F. Direct matching grant

1. Instead of giving the matching grant to the donor the government could administer a system in which it gave its matching grant directly to the public benefit organization. For example, public benefit organizations could file a quarterly report with the government indicating how much private grants it has raised. The government could then simply write it a cheque directly for whatever percentage it had agreed to match.

#### G. Comment

1. Once again, arguments around which form the tax concession for public benefit donations should take soon get complicated. Since I suspect that this question is not being reconsidered at this time in Lithuania, I will not pour through the arguments. Suffice it to note that (in my view) the most equitable, efficient, simply, transparent, and accountable form is a direct matching grant system. If the government is unwilling to undertake that form of subsidy for public benefit organizations, and if there was a concern that it would not encourage individuals to give, the next best form is a tax credit (among other reasons, the rate of the credit can then be set apart from the basic rate of tax). I understand that a form of dedicated tax payment system is being considered in Lithuania. I was not asked to comment on this innovation, and perhaps in countries that are trying to build up a civil society, any form of support the government is willing to extend to civil society should be taken. Also, I have not had time to turn my mind seriously to considerations relating to the so-called Hungarian innovation. However, I do have a couple of preliminary, minor

reservations about it and, as a matter of interest, simply set them out in the next section.

H. Dedicated tax payment - citizens can allocate some percentage (2%) of taxes to designated organizations (equivalent to a 100% tax credit)

1. If citizens are allowed to allocate some amount of taxes to public benefit organizations, at the very least, the amount should be expressed as a fixed amount instead of some percentage of the income tax they owe.

a) A dedication expressed as a percentage of income taxes paid does not allow those who, because of low or no taxable income, pay no income tax to allocate any portion of government finance. This makes no sense. On the grounds of equality and the basic rationale of promoting civil society - namely to promote diversity and pluralism - all citizens ought to be able to decide what NGOs receive assistance. Moreover, there is no reason why a scheme of dedication should be tied conceptually to the income tax. Even those who do not pay income tax pay other taxes such as value-added taxes and property taxes.

b) There is no reason why a person who pays \$2,000 in income taxes should be able to allocate more than a person who pays only \$200. In a democracy, rich people have no more say (in theory) over the expenditures of government funds than low-income people. Why should it be different for financing civil society?

c) That is to say, at the very least, instead of 2% of their taxes paid, all citizens should be able to allocate, say \$100 (whatever fixed amount would result in the same expenditure of government finances as 2% of taxpayer's tax owing), of government funds to NGOs of their choice.

2. Aside from its form, there are a number of problems with a system of dedicated tax payments

a) One reason for matching some portion of private donations to public benefit organizations is to encourage private giving and thus reduce the cost to government of providing public goods and services. Some analysts claim that in a tax credit scheme in which the government basically matches the private donations of taxpayers, the additional incentive to give provided by this government matching grant (tax concession) completely offsets the cost to government. (As a simple illustration - assume that a person would be willing to give \$10 to a public benefit organization in the absence of any tax concession. If the government now provides the person with a 50 percent tax credit for the amount they give to the organization the person could now give \$20 and still be no worse off than before. However, some analysts contend that with the tax credit the person is likely to give even more than \$20. Thus the \$10 cost to the government has generated an even greater amount to civil society.) A scheme in which individuals do not have to put up any of their own money in order to dedicate part of the government's finances obviously provides no incentive for individuals to give more of their own money and indeed is likely to diminish citizens' incentive to give. Thus, it will be very expensive to the government and the public benefit organization sector might not be much better off. It might be the case that in Lithuania individuals are not in the habit of giving to public benefit organizations, however, it might make more sense to try to encourage that habit in the long run through more generous tax credits than suppressing it entirely through a tax dedication scheme.

b) Another reason for encouraging people to donate to public benefit organizations by providing a matching grant scheme is to encourage them to give so that the values underlying civil society will be fostered - reciprocity, commitment and caring for others. Arguably a tax dedication scheme does nothing to foster these values. It does not require any expression on the part of citizens of a commitment to civil society.

c) A tax dedication scheme would appear to reflect and reinforce a distrust of

government decision-making abilities

d)Incidentally, with a tax deduction scheme it becomes even more anomalous to include religion as a public benefit organization and, at the very least, it will be important not to allow individuals to deduct all of their tax to a church or to allow churches to form other public benefit organisations to which individuals can deduct their taxes.

**XXIX.Should There Be Any Limitations on Donations that Might Qualify for Special Income Tax Concessions Such As Percentage of Income Limits, Limits on the Type of Property Donated, or Conditions Attaching to the Donation?**

**A.Percentage of Income Limits**

1.Should there be a floor below which contributions are not deductible, perhaps 2% of income, on the grounds (1) that this will save administrative costs and (2) that the tax incentive is unlikely to motivate small contributions?

2.Should contributions that receive preferential tax treatment be restricted to some percentage of income (7% or 20% or 50%) so that wealthy families cannot control an undue amount of benefits?

**B.Type of Property That Qualifies as a Donation**

1.Should there be special treatment for donations of capital property?

2.Should donated property that attracts preferential tax treatment exclude used property?

3.Should the value of personal services receive preferential tax treatment? The draft allows individuals to deduct the value of services contributed to a public benefit organization. I am told that this only applies to business persons who would then be disallowed the deduction of that person's services as a business expense. While this might be unobjectionable, the better position - I think - is to only allow taxpayer's to deduct the value of property (and not services) contributed to a public benefit organization. Clearly someone who is not an employee of a business should not be able to deduct the value of the services they contribute to a public benefit organization since they did not pay tax on the value of those services. Also, even if a business that allows an employee to work for a public benefit organization can double deduct the value of the services as a sponsorship it might be better off even if it cannot deduct the employment expenses. It occurs to me that it is much simpler, and less prone to abuse, to provide that only the fair market of property (or the tax cost) can be deducted as a sponsorship and if any business allows its employees to work for a public benefit organization simply allow them to continue to claim the individual's salary as a business expense.

**C.Conditions Attaching to the Donation**

1.A donation should only include a gift, that is a "voluntary transfer without valuable consideration." Thus transfers of property would not qualify as a donation if it was an admission fee, membership fee which conferred some form of benefit, lottery ticket, tuition fees, or a gift where the donor has instructed the charity to dispose of the gift to a particular person.

2.There is nothing offensive about the donor dictating how the gift is to be used so long as that use is a public benefit activity

3.There is nothing offensive about the donor demanding some recognition for the gift such as an acknowledgement or a facility or scholarship named after the donor. However, if the request by the donor would cost the public benefit organization more than an insubstantial sum, for example to advertise the gift in some way that required more than an insubstantial outlay by the organization, then it would not qualify as a donation since it would not be "voluntary transfer without consideration."

4.Business appear to be increasingly interested in "cause marketing," that is, supporting or sponsoring specific activities that help sell a product or build a positive image among a

target group of potential consumers. This is regrettable since it means that the priority of NGOs is influenced by the whim of business interests, but so long as the condition attached to a donation does not require more than an insubstantial outlay by the public benefit organization it would appear to be unobjectionable from a policy point of view. 5. In Article 8 the draft appears to contemplate that business interests will be able to attach some condition to gifts. Again, within the guidelines suggested above, so long as the condition does not impose greater than an insubstantial cost on the organization, say more than 5 percent of the value of the gift, there might be nothing objectionable about attached conditions, although, since they might distort the public benefit organizations spending priorities, they should not be encouraged.

### **XXX. What Portion of the Public Benefit Organization's Income Should Be Exempt from Tax?**

A. I take it that under present Lithuanian tax law only the amounts that charities receive from sponsorship donor's are tax exempt. The draft proposes to make anonymous donations tax exempt as well as sponsorship donations, see Article 2(2). I agree with this change but would go even further. All of the income of public benefit organisations should be exempt, whether received as a gift or earned as investment income or business income. Aside from the public policy argument for exempting all of its income from tax - it is all going to be used for public benefit activities so why should it be taxed - it is simply not income in the normal sense of that concept. That is to say, it is not accruing for any particular individual's benefit and therefore there is no justification for taxing it under an income tax.

### **XXXI. What Tax Relief Should be Provided to Public Benefit Organizations Under other Tax Regimes?**

A. I only add these few comments out of a sense of completeness. I appreciate that they are beyond the areas now being considered and that the European Union has developed directives on these issues.

B. VAT - The best situation for an NGO is to be zero-rated under a VAT. That is, that though the NGO pays VAT on the goods and services it buys, it does not have to pay output VAT, and it gets back as a rebate the input VAT paid.

C. Customs duties - The best situation for NGOs is to be given preferential treatment or an exemption from customs duties on imported goods and services that are used to further their public benefit purposes. However, this opens up the opportunity for dishonest importers to establish NGOs for the sole purpose of obtaining a custom exemption. Therefore, to prevent abuses, the law should clearly state that the exemption is only available if the imported goods or services are to be used by the NGO in its operations (and not for resale) and the NGO should be required to report the item imported and the continued use made of it.

D. Property and other taxes - Practices vary greatly. Generally churches are exempt from property taxes but not other NGOs.

E. Employment or payroll taxes - Since these taxes generally finance social security schemes for employees, those who are employed by NGOs should not be excluded from their benefits and thus NGOs should not be exempt from paying them.

## **IX. Miscellaneous Considerations**

### **XXXII. Should There Be Rules Regulating Fund-Raising?**

A. There should be, but this is another story and maybe is not a problem in Lithuania.

**XXXIII. What Should the Penalties Be if a Public Benefit Organization Violates the Laws Applicable to It?**

A. There are countless ways that a public benefit organization might be in violation of the law: failure to file reports on time (or at all), makes part of its income available to members other than by paying them reasonable salary or compensation for expenses, donates some of its income to nonqualifying organizations, carries on a prohibited business activity, fails to meet the disbursement quota, provides support to a political party, and so on.

B. Fines and Penalties. A system of fines and penalties would appear to be appropriate for such offences as failure to file a report on time or the filing of false information. Offences such as self-dealing or the obtaining of a private benefits by a director or member would also appear to be best regulated through the use of fines and penalties. These might be levied against the organization itself or in some cases against the directors, particularly if the directors were grossly negligent or engaged in fraudulent activity.

C. Deregistration. If an organization fails to file returns or commits other offences after an appropriate notice, it should be subject to deregistration. Once deregistered an organization cannot, of course, issue receipts for tax concessions; it should become liable to tax on its profits in the same way as any other organization; and, all of its assets should be expropriated (or be required to be disbursed to other public benefit organizations).

**XXXIV. What Should the Consequences Be When a Public Benefit Organization Winds Up or Dissolves?**

A. If a public benefit organization voluntarily winds up it should be required to disburse all of its assets to other public benefit organizations.

B. The organization might be required to give notice in a local newspaper and in the appropriate government publication.

C. In the application for winding up the directors should be required to certify that the appropriate bylaws have been passed, that other required procedures have been followed, and that the organization has no debts and no assets.

**XXXV. What Restrictions Should Be Placed on the Foreign Activities of Public Benefit Organization?**

A. Should it be allowed to carry on its activities abroad?

1. Presumably yes, so long as it does so directly (or through an agent) or if it is in a joint venture arrangement so long as it retains significant control. If the public benefit organization does not retain control there is no way of ensuring that the money is being used for public benefit activities

B. Should Lithuanian citizens have the same tax concession privileges if they donate money to foreign qualified charities?

1. In order to ensure control over the use of the money, most jurisdictions do not provide tax concessions to citizens who donate to foreign charities. They fear lack of regulation in the foreign country and the risk that the money might be misappropriated.

C. Should tax treaties provide for "similar treatment" of foreign public benefit organizations?



1. Tax treaties often so provide, therefore, foreign charities would not be taxed on their income earned in the source country.

**XXXVI. Should Donors to Some Organizations that Do Not Qualify as Public Benefit Organizations Still Be Entitled to Tax Relief?**

A. There might be some organizations that the government wishes to encourage people to make donations to even though they do not meet the technical definition of public benefit organisations and, therefore, are not subject to the reporting and other requirements. The following are a few such examples:

1. Government agencies
2. United Nations or its agencies
3. A charity outside Lithuania with some connection to Lithuania - for example, a university attended by Lithuania students

**XXXVII. Should There Be a Special Division in Government (In Addition to the Oversight Division) Responsible for the Encouragement, Coordination of, and Assistance to NGOs?**

A. Everything should be done to make it as easy and inexpensive as possible to form NGOs. There is a need for an agency within government to coordinate the interaction of civil society and the government so that resources are deployed in a way that ensures that these two sectors of society are complimentary. This is important since many NGOs will be reluctant to approach an oversight body with questions and concerns. Moreover, this government division should be responsible for capacity-building within civil society.

B. The specific responsibilities of the policy coordinating unit in government might include

1. Provide support, information, and advice about best practices to voluntary organizations related to improving accountability and governance
2. Collect and provide information to the public
3. Evaluate and make recommendations on registration of new applicants
4. Assist organizations to maintain compliance with the legal and other regulatory requirements that apply to them
5. Investigate public complaints

C. The government might consider making a Cabinet Minister responsible for civil society.

D. Some governments, such as the UK government, have entered into a social compact with the voluntary sector that sets out the relative rights and responsibilities of the two sectors in relation to one another. It is a sign of a declared commitment on both parts. Other ways of ensuring the promotion of understanding and agreement between the sectors should be explored.

**XXXVIII. What Should the Role Be of Intermediary Organizations?**

A. Umbrella organizations within civil society, such as the Non-Governmental Organization Information and Support Centre, should be encouraged and supported, most appropriately with at least a modest amount of core funding. These types of intermediary associations play a vital role in a number of ways:

1. Provide information and services to other organizations, especially those which are new, small and have limited resources
2. Offer training programs
3. Create forums for discussion and liaison with governments and the private sector
4. Identify new needs and issues
5. Set standards for the sector
6. Raise the profile of NGOs and the sector as a whole and serve as an advocate for their

interests

#### B. Self-regulation

1. These organizations should encourage individual NGOs to adopt explicit standards to regulate their own activity
2. Groups of NGO should be encouraged to set higher standards of conduct and performance through self-regulation.
3. Organizations that monitor and evaluate organizations in the NGO sector should be encouraged

### XXXIX. What Provisions Should a Model Public Benefit Organization Statute Contain?

A. Outline of a Model Public Benefits Organization Statute. In the same way that I suggested the outline for a model nonprofit organization's statute above, so that a comparison might be made with a statute that governs public benefit organizations, I set out here the outline for a model statute governing public benefit organizations.

#### 1. Definition

- a) Definition of Public Benefits Organization (see definition above)
- b) Definition of Public Benefits Activities (see above)

#### 2. Registration Process

- a) Documents to be Filed (see above)
- b) Procedure
  - (1) Time to reply
  - (2) Reasons for refusal
  - (3) Right of appeal

#### 3. Governance

- a) (Normally all the rules of governance as they apply to nonprofit organizations would apply to public interest organizations, however, if there are not rules in such statutes carefully setting out such things as the duties and liabilities of directors, prohibitions on personal benefits, and so on they might have to be set out in this statute.)
- b) Conflicts of Interest
  - (1) Above I suggested some special rules that should apply to public interest organizations to avoid any possible conflict of interests between related individuals and the organizations. These rules are likely to be tougher than those found in the statute governing nonprofit organizations and therefore should be found here.
- c) Supervisory Body or Audit Committee
  - (1) As an additional check on their activities, some statutes require public benefit organizations over a particular size to appoint a supervisory or audit committee.

#### 4. Disbursement Requirements

#### 5. Limitations on Activities (the limitations discussed above - to the extent they apply - should be found here).

1. Commercial Activities
  - a) Investment Activities
  - b) Political Activities
  - c) Foreign Activities

#### 6. Reporting and Transparency Requirements

- a) Annual reporting requirements
  - (1) Small organizations
  - (2) Large organizations
- b) Accounting for receipts for donations

- c) Retention of books and records
- d) Availability of records to the public
- 7. Dissolution
- 8. Deregistration and other penalties
- 9. Appeals
- 10. Entry into force

END